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Department of the Treasury  
Washington, DC 20224

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Person To Contact: \_\_\_\_\_, ID No. \_\_\_\_\_

Telephone Number:

Refer Reply To:  
CC:PSI:B03  
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Date:  
December 22, 2008

### Legend

Company =

Common Parent =

State =  
ESOP =

## Family

CEO =

Trust =

a =
$$\underline{b} =$$

**C** =

d =

e =

f =

g =

Dear :

This letter responds to a letter dated October 24, 2008, submitted on behalf of Company by its authorized representative, requesting rulings under § 1361(b)(1)(D) of the Internal Revenue Code.

### FACTS

The information submitted states that Company was incorporated on a under the laws of State. Company was formed to serve as a holding company for several directly and indirectly owned subsidiaries ("Subsidiaries"), including Common Parent. Company has issued both voting and non-voting common stock and represents that all shares of Company stock have identical rights to operating and liquidating distributions. Company elected to be treated as an S corporation effective a, and intends to make elections under § 1361(b)(3) to treat most of the Subsidiaries as qualified subchapter S subsidiaries ("QSubs") effective b.

Common Parent was previously the common parent of the other Subsidiaries. As a result of certain events occurring into c, Common Parent was restructured through a redemption transaction ("Redemption") that resulted in Common Parent being owned by Family, the ESOP, and two other stock plans. Later, incident to Company's formation on a, the shareholders of Common Parent exchanged their stock in Common Parent for stock in Company, and Common Parent became a wholly-owned subsidiary of Company.

To ensure that the terms of the Redemption were fair to the ESOP and the two other stock plans ("Plans"), Common Parent engaged an independent fiduciary to review and evaluate the Redemption on behalf of the Plans. To ensure that the value of stock shares held by the Plans would not be diminished by the effects of the Redemption, the fiduciary insisted that the Plans' participants be guaranteed a "floor" redemption price of \$e per share through f ("Floor Price Agreement") and that the valuation of such stock be on a marketable minority interest basis ("Valuation"). The Floor Price Agreement and the Valuation methodology ("Provisions") were adopted by the Plans. Later, the two other stock plans were merged into the ESOP as of d. Thus, all valuations of the ESOP shares of Company stock are to reflect the value of shares as determined by an independent appraiser.

Among its provisions, the ESOP provides that it shall distribute benefits to participants at stated periods of time for termination of employment, retirement, disability, or death. The ESOP also provides for distributions to participants for in-service diversification, whereby participants may elect to diversify upon reaching a certain age with a certain number of years of participation in the ESOP. Under the ESOP, any distribution of a participant's benefit may be made in cash, in Company stock, or in both. However, the ESOP requires that any Company stock distributed to a participant be immediately resold to Company.

In g, Common Parent entered into split-dollar insurance agreements with CEO and Trust, both of which are shareholders of Company. Common Parent is obligated to pay the premiums on the policies, and CEO and Trust are obligated to pay Common Parent an amount equal to the annual cost of the life insurance protection under their respective policies. Upon the death of the life insured under each policy, Common Parent has the right to receive a portion of the proceeds of the policy equal to the total amount of premiums paid by Common Parent. If a policy is terminated prior to the death of the life insured, Common Parent will be paid an amount equal to the lesser of the amount of premiums paid by Common Parent or the cash surrender value of the policy. The policies will terminate at the option of Common Parent if CEO ceases to be an employee.

Company requested rulings that it will not be considered to have a second class of stock in violation of § 1361(b)(1)(D) solely as a result of the existence of the Provisions or the split-dollar insurance agreements.

## LAW & ANALYSIS

Section 1361(b)(1)(D) provides that for purposes of subchapter S, the term "small business corporation" means, a domestic corporation which is not an ineligible corporation and which does not have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively,

the governing provisions). A commercial contractual agreement, such as a lease, employment agreement, or loan agreement, is not a binding agreement relating to distribution and liquidation proceeds and thus is not a governing provision unless a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(iii)(A) provides, in part, that redemption agreements are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation rights unless (1) a principal purpose of the agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l), and (2) the agreement establishes a purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below fair market value of the stock and, thus, are disregarded in determining whether the outstanding shares of stock confer identical rights.

Section 1.1361-1(l)(2)(iii)(B) provides that bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. In addition, if stock that is substantially nonvested (within the meaning of § 1.83-3(b)) is treated as outstanding under these regulations, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Furthermore, the Commissioner may provide by Revenue Ruling or other published guidance that other types of bona fide agreements to redeem or purchase stock are disregarded.

Regarding the ESOP and its distribution provisions, Company's agreement to redeem stock is activated by a participant's termination of employment, retirement, disability, death, or in-service diversification. Under § 1.1361-1(l)(2)(iii)(B), agreements to redeem stock upon termination of employment are disregarded. In disregarding agreements that provide for redemptions upon termination of employment, § 1.1361-1(l)(2)(iii)(B), in effect, distinguishes between redemption agreements for stock of employee shareholders and redemption agreements for stock of investor shareholders. In this case, the shareholders whose stock is to be redeemed are employee shareholders, rather than investor shareholders. Though specifically referencing redemptions upon termination of employment, as well as death, divorce, and disability, § 1.1361-1(l)(2)(iii)(B) also anticipates that other types of bona fide agreements to redeem stock

may be disregarded by the Service. In addition, a redemption agreement is disregarded under § 1.1361-1(l)(2)(iii)(A) where the principal purpose of an agreement is not to avoid the one class of stock requirement or the agreement sets a purchase price that does not greatly vary from the fair market value of the stock.

Regarding the split-dollar insurance agreements, because the agreements provide that, at the time Common Parent pays the premiums, CEO and Trust must pay Common Parent an amount equal to the annual cost of the insurance protection, the split-dollar insurance agreements do not alter rights to distribution and liquidation proceeds relating to Company stock.

### CONCLUSIONS

Based on the facts submitted and representations made, we conclude that the Provisions will be disregarded in determining whether the outstanding shares of Company stock confer identical rights. Therefore, for purposes of § 1361(b)(1)(D), Company will not be considered as having more than one class of stock as a result of the Provisions. In addition, we conclude that Common Parent's split-dollar insurance agreements are not a vehicle to circumvent the one class of stock requirement for Company. Therefore, for purposes of § 1361(b)(1)(D), Company will not be considered as having more than one class of stock as a result of the split-dollar insurance agreements between Common Parent and CEO or Trust.

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the foregoing facts. Specifically, we express or imply no opinion on whether Company's S corporation election is valid under § 1362(a), or whether the Subsidiaries qualify as QSubs under § 1361(b)(3). In addition, we express or imply no opinion on whether the ESOP is qualified under § 401(a) or whether the redemption of the ESOP shares under the Provisions may violate the nondiscrimination requirements of § 401(a)(4).

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to Company's authorized representative.

This ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

/s/

Leslie H. Finlow  
Senior Technician Reviewer, Branch 3  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)  
Copy of this letter  
Copy for § 6110 purposes